

Emerging market debt – moving into the mainstream

Prisma, Zurich Life's fund platform, focuses attention on the building of risk rated portfolios for your clients. Diversification across asset classes is essential in portfolio construction and the **Prisma Platform** gives your clients access to all investment sectors. Emerging market debt is an asset class that is new to many, yet we think it is time for this asset class to move into the mainstream.

We asked **Paul Bowen of Pictet Asset Management** to explain why they think emerging market debt is potentially the **asset class for the post-crisis investment world** and why the Emerging Local Currency Debt Fund may be well placed to deliver good returns for your clients.

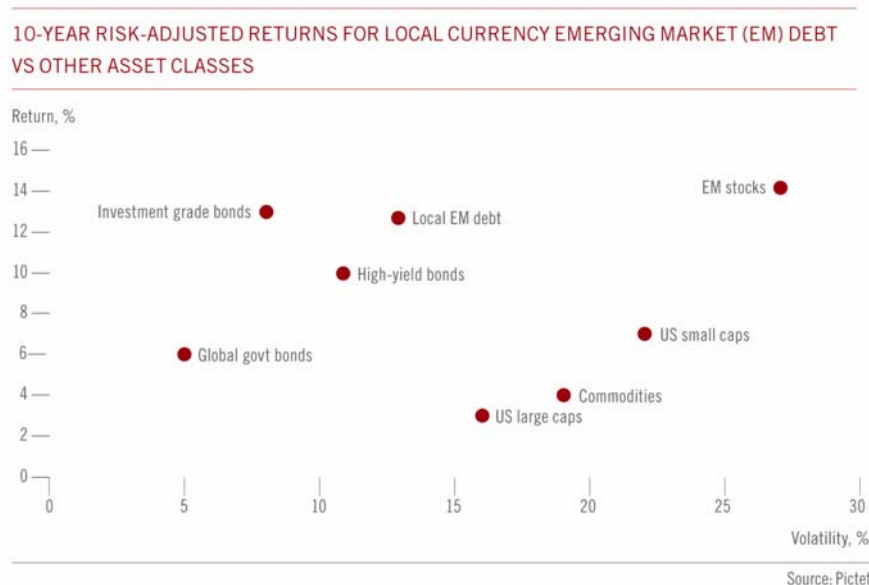
And then there were three.

Thanks to a recent flurry of debt downgrades, the only G-10 economies left carrying stable triple-A ratings from the major credit assessment agencies are Canada, Switzerland and Sweden*. The ratings cuts serve to reinforce what is already widely accepted – that the debt crisis has made developed government bond markets a riskier place to invest.

However, viewed from a different vantage point, the ratings reductions cast an ever more favourable light on the creditworthiness of emerging markets. No longer the Achilles heel of the world economy, these countries now possess the growth potential, public finances and credit ratings record that are the envy of many of their developed counterparts. Moreover, the factors that have driven the significant improvement in emerging markets' credit profile can be expected to remain features of the investment landscape for some time to come.

Despite this favourable backdrop, local currency emerging market debt has yet to acquire the mainstream investment status it deserves. Investors have yet to fully embrace the asset class, and continue to see it as more of a tactical rather than strategic holding. However, as recent events suggest, a reassessment is long overdue.

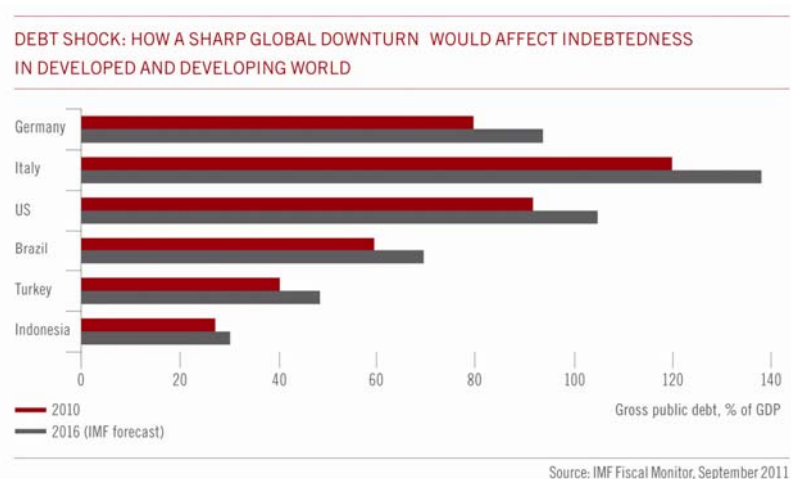
As you can see from the graph below (Pictet Asset Management, March 2012) the risk-return profile for local EM debt is very favourable compared to the more traditional asset classes. The favourable risk-return profile for emerging market debt stems from a number of strong secular and cyclical trends – shifts that are likely to gather momentum as the global economy recovers from the credit crisis.



Among the most prominent are:

Better fundamentals compared to developed world

By implementing reforms that have boosted their economic growth potential, reduced sources of inflation and eased current account imbalances, emerging markets have been able to place their finances on a more stable footing. This gives them the monetary and fiscal firepower to counteract any slowdown in demand in the developed world. Research from the International Monetary Fund (Sept 2011) shows that while a protracted worldwide slowdown lasting until 2016 would have a significant impact on advanced economy debt burdens, it would have a far more modest impact on emerging markets' indebtedness.



Improving credit profile

Credit ratings have consistently improved: more than 75% of local currency emerging market sovereign bonds are now investment grade* – a development that sits in stark contrast with deteriorating credit profile of governments in the developed world.

Attractive yields

Yields on local currency debt are, at around 7%*, high compared to similarly-rated debt issued by borrowers in advanced economies. With many developing nations both better equipped and more willing to bear down on inflation than at any point in their history, be it through monetary policy, deregulation or labour market reform, there is plenty of scope for real and nominal bond yields to fall over the long term – a potentially strong source of return.

Scope for long-term currency appreciation

Many currencies, historically a key source of return for emerging market bond investors, have fallen to levels that are low relative to countries' long-term economic prospects and their expected future share of global trade.

Diversification benefits

Because local currency bonds are heavily influenced by domestic fiscal, monetary and macroeconomic policies, they can offer an attractive risk-reward trade-off for investors seeking currency diversification. Emerging market bonds' correlation with other mainstream asset classes is moderate.

Positive technical backdrop

Markets are easier to access and more liquid for a number of reasons:

- **Active debt management:** governments are steadily replacing external debt with local currency financing wherever possible to reduce foreign exchange risk and lower exposure to external shifts that can weigh on risk appetite.

- **Deepening pools of local institutional demand:** the institutionalisation of pension funds in several Latin American countries, including Mexico, Chile and Colombia, is creating a stable buyer base for domestic debt.

While prospects for the asset class are favourable over the long term, investors will inevitably experience some volatility in the years ahead. At this particular point in the global economic cycle, for instance, the near term outlook is not particularly clear - emerging markets will not remain immune from the effects of the debt crisis in the industrialised world. The euro zone sovereign debt crisis and the potential for a sharp slowdown in China remain a concern over the near term.

Yet, investors with a long-term time horizon could potentially be rewarded by making a strategic allocation to emerging market debt. In the majority of cases, these economies have developed into reform-minded nations that promise strong rates of growth, credible policymaking and sound public finances – allowing them to become an even bigger force in the world economy.

Local currency emerging market debt is a deeper, more varied and liquid market than at any point in its history – giving investors the opportunity to better manage the trade off between risk and return. In many ways, it is an asset class for a post-crisis world.

To learn more about the Emerging Local Currency Debt Fund and how it fits within the Prisma Platform, just speak to your local Zurich Life Broker Consultant.

Warning: Past Performance is not a reliable guide to future performance.

This article is intended for information purposes only and should not be relied upon without seeking appropriate advice.

*Source: Pictet Asset Management, October 2012

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